Sales Tax Automation

White Paper

Automation: A Company's Best Ally Against Sales Tax Audits

Avalara: Making Sales Tax Less Taxing

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There is no formula that will guarantee a business' sales and use tax reports will never be audited, but that does not mean owners can (or should) do nothing until an audit occurs.

Automation can provide a proactive sales tax compliance vehicle that is flexible, scalable, and cost efficient for reducing audit risk, minimizing or eliminating penalties and interest, and keeping up-to-date with rules and regulations down to the rooftop level.

Introduction

Calling sales and use tax management a challenge for every business is an understatement. No one needs to be reminded of the possibility of major financial repercussions when a taxing agency questions the figures. Auditor findings of improper or inadequate tax payments have led to the failure of many businesses, despite companies' attempts at compliance.

Owners may not realize their level of exposure to audits and the crippling findings that may await them despite their best efforts to comply with the law. While larger businesses and industries generally have the resources to plan and budget for sales and use tax audits, most others simply cannot afford the luxury. Making matters worse, such audits are not easily predictable. As a result, many owners may not recognize that their tax reporting practices are likely to trigger the dreaded notice of a pending audit from the state.

There is no formula that will guarantee a business' sales or use tax reports will never be audited, but that does not mean owners can (or should) do nothing until an audit occurs. Unfortunately, in many cases, that's exactly what happens when they rely on accountants, manual processes, and limited software solutions in the hope that the reports they generate will satisfy auditors. Today these methods are insufficient to handle the countless number of tax laws and regulations, particularly for businesses operating in multiple states or online. However, there is an alternative: technologically advanced automation.

Automated solutions help businesses improve their reporting and workflow processes so they can comply with the myriad of sales and use tax laws and stand up to any audit examination. In fact, state-of-the-art automation ensures that each company is prepared and protected should an audit occur.

Problems and Challenges

Many companies have increased risk of sales and use tax audits by relying on manual reports and spreadsheets. "The errors associated with such methodology have contributed to negative audit results subjecting the companies to have fines/penalties and cost of corrective labor,"[1] concluded one report that extensively detailed how businesses unwittingly leave themselves unprepared despite their best efforts at compliance.

Statistics from this research should be considered red flags for anyone in charge of tax compliance. The figures are proof positive about the risk of audit exposure and whether it is unknowingly increased by relying on older technologies.

Those who responded to the survey had a variety of opinions about the top pressures driving company sales and use tax management policies and adoptions. Their answers illustrate the number of issues facing everyone from CFOs to tax accountants to owners of small businesses.

Survey Results

Top Pressures Driving Company Sales and Use Tax Management Policies and Procedures

- 49% - Compliance with jurisdictional rules and regulations
- 47% - Increased activities by government auditors
- 43% - Lack of staff with tax expertise
- 34% - High cost of negative sales and use tax audits
- 27% - Mandate to increase organizational productivity[2]

Despite these pressures, it can be concluded that many companies still maintain what is, at its core, a reactive tax management policy that relies on manual reporting, sales tax tools unconnected to the rest of the operations, or tax tools contained within their Enterprise Resource Planning (ERP) system. What is needed to face the dizzying array of sales and use taxes is a proactive approach based on modern automated technology to decrease exposure risk while staying current with the countless number of changes in state tax regulations.

Auditors Look Far Deeper Than Simple Rate Calculation

Companies are likely to find that one of the biggest problems with insufficient tax management policies is their inability to be comprehensive, let alone up-to-date on changes to state tax laws. One reason is that earlier solutions were targeted to niche areas, specifically calculation. This focus can be attributed to the growth in complexity of ever-changing tax formulas leading companies and their accountants to conclude that manual calculation and tax software programmed for those formulas offered the best chance at compliance and audit protection. Unfortunately, this was a flawed response because of what they failed to take into account: workflow and process.

Why are workflow and process so important? Because tax calculations do not occur in a vacuum and auditors know it, which is why calculations alone are not their only concern. They also demand an explanation about the environment in which the calculations occur, an environment of workflow and process, two areas generally foreign to accountants whose reporting is based on calculations and formulas.

The same holds true for tax reporting software that tends to be less comprehensive. For state auditors, that focus is insufficient. They insist on a provable rationale behind calculations and computations. As many companies can sadly attest, auditors will be more than skeptical if there is no easily understandable and provable process. It is an omission bound to lead to a finding for recovery and a potential major hit to the company's bottom line.

State Sales Tax Fiscal Environment

Cash-starved state governments and the tax auditors who represent them are likely to give companies little latitude on sales and use tax calculations, compliance, and reporting. Their relentless efforts appear to be paying off, as the U. S. Census Bureau reported in a recent summary of state and local government tax revenue.

"Fourth Consecutive Quarter of Tax Revenue Gains"

Report Headlines U. S. Census Bureau

According to the report, state tax revenue was up 5.21 percent. General sales tax revenue followed that trend by increasing to $72.1 billion from $69.3 billion above the same quarter in 2009—an overall 4 percent increase[3].

Among some of the states showing unusually large gains in sales tax revenue are:

- North Carolina—26.6 percent
- Minnesota—24.2 percent
- North Dakota—21.3 percent
- Utah—20.9 percent[4]

The lesson is clear: Despite a down economy, state taxation departments have been able to increase their collections by microscopically analyzing sales tax payments. There can be no question that some of those revenue gains can be attributed to inadequate reporting that fell short of the auditors' requirements, providing states with additional funds to help their dwindling coffers and forcing companies to face cash flow problems due to costly tax penalties. This should be understood as another glaring example of an inadequate tax management policy lacking satisfactory audit protection—and the problems don't end there.

Hidden Costs

Any attempt to uncover an inherent exposure risk in a manual, or standard ERP sales and use tax reporting approach begins with an analysis of the company's business model. Chances are, provisions for sales and use tax compliance have not been included, and it's rare to find a model that contains them.

As is often the case, reporting and compliance are on the planning and budgeting back-burners when they should be up front. That's born out by another Census Bureau report that cites the costs of sales tax compliance and penalties for non-compliance as major reasons for many business failures.

The cost of sales tax compliance can be as low as three percent of a company's budget, which is considered very efficient. However, this percentage is an unrealistic expectation for companies that rely on manual and/or spreadsheet software reporting. In fact, some businesses may have to shoulder as much as 15 percent of their budget on compliance, which is a costly inefficiency that can be easily avoided through modern automated technology.

An alarming statistic in a recently published report shows that many financial officers underestimate the cost of sales and use tax compliance by 50 percent because they have limited visibility and understanding of their billing and procurement processes[5]. What should be even more troubling, especially for those companies that can least afford it, is that the average penalty cost of a negative sales and use tax audit is $34,000 per occurrence, based on research of mid-market CFOs and senior financial officers[6].

The same report highlights other hidden costs of manual and spreadsheet tax compliance. It finds that preparing and remitting sales and use tax forms takes a full 24 accounting days per year[7]—an expensive figure regardless of company size. Researchers also found that on average, with the exception of very large companies, many businesses can expect to pay more than $327,000 annually for sales and use tax compliance[8].

These figures explain why more companies are turning to automated systems to help keep their sales tax reporting current, compliant, and cost efficient. They have too much to lose without the ability to present a full picture of their workflow and process that an automated system can generate and auditors will demand to review.

Despite a down economy, state taxation departments have been able to increase their collections by microscopically analyzing sales tax payments. Revenue gains in 2010 can be attributed to increased audit activity resulting in greater scrutiny and identification of sales tax compliance issues. This scrutiny has resulted in increased penalties and fees.

An Inside Look at State Audits

There's no question about it. State audits are on the increase. A study conducted by a marketing research firm has determined that a company can count on receiving one or more audit notices a year[9]. Even more surprising, the report notes that 33 percent of mid-market companies are just as likely to be hit with 11 or more audit notices[10].

Businesses may wonder how their state determines the target of an audit for sales and/or use tax compliance. There is no clear answer. Targets for such examinations are determined by the states themselves, and the formula for selecting the businesses is never disclosed.

States tend to base many audits on a sampling of returns, however, there are other processes and patterns that can cause consideration. One obvious pattern is a questionable or inconsistent payment process that lacks adequate calculations, formulas, and other documentation. State tax computers are likely to red-flag any reporting that fails to stand up to what the tax authority views as a consistent and verifiable process.

Ohio offers an example of what many state departments of revenue are likely to target—insufficient or non-payment of use taxes, according to John Trippier, deputy auditor, Ohio Department of Taxation. "That is going to be our primary focus," Trippier said. "From an audit perspective, 96 percent of our use tax audits generate liability"—

a figure that should make any financial officer want to evaluate the company's tax compliance process.

The Ohio deputy auditor said liabilities from use and/or sales tax findings have been as high on some occasions as "in the millions." What he finds even more surprising is the lack of knowledge about use tax compliance, including failure to register with the state.

"We estimate 380,000 companies from small to large have failed to register for use tax compliance and when we question them, what we usually hear is they didn't know they had to register or were unfamiliar with requirements," Trippier said.

He disclosed that state examiners are likely to target companies that have registered for sales tax reporting but have overlooked the same responsibility for use taxes. That oversight changes the scope of the audit. For registered Ohio companies, the auditors require only four years of documented transactions; for the unregistered, the auditors will demand to see seven years of transaction records. From the audit and penalty side, that can be costly.

Auditors have found that automated systems "...definitely help" for improving sales tax audits results in showing company compliance.

Triggers for sales tax audits include:

- poor, manual processes
- inconsistent reporting for the industry
- unusual amount of non-taxed transactions
- statistical eventuality

Trippier agreed that a documented process is critical to resolving any potential issues—and that, too, is a problem for companies that do not realize its importance and have nothing in place. "Sometimes there is no process," he said. The auditor indicated that a lack of process can make it even more difficult for a company to justify its calculations and payments.

Trippier said his experience with automated sales and use tax reporting has been very positive. "They definitely help," he said. "I've found that their reports contain a substantially correct amount of liability."

Businesses can and should expect an audit notice from the state under some conditions. The most obvious is a new registry on the tax rolls since that would be the first record the state has of the company's operations. A decision to audit can also be based on a mere statistical sample of business reports or it could be triggered by information provided to the taxing authority including in the form of a complaint.

In fact, it is this whole concept of "triggers" that tends to escape manual and spreadsheet reports, but is expressly covered with automated reporting. One such item included in automated audit protection, but not likely found in traditional tax management approaches, is a high difference score between a company's report and the norm a department of revenue or taxation expects.

High difference scores are always red-flags for examiners, but accounting-only software is unlikely to uncover them. Another obvious trigger is a report or lack of one that covers all sales channels such as direct, retail, and Internet. If the company is a manufacturer, expect the state to look microscopically at any agreement the company has with its fulfillment house on remitting sales and use taxes.

Exemption certificates can be triggers as well. Taxation departments tend to question whether all non-taxed transactions are in line with the certificate, and a thorough analysis of such transactions is mandatory as part of an audit protection plan. "Many vendors don't get properly completed exemption certificates," said Ohio's Deputy Auditor Trippier.

A different potential trigger exists for use tax liability. This trigger focuses on the issue of nexus—whether a business has a physical presence or connection in a state. At one time, companies could use the decision by the U.S. Supreme Court in Quill Corporation v North Dakota (1992) as a guideline. In that case, the court found that the state could not require Quill to collect and pay a use tax on sales shipped into North Dakota unless the company had a "substantial nexus" there. The state had argued that Quill's software use in the state qualified it for the tax, but the Supreme Court disagreed based upon the absence of a physical presence or connection[11].

Now some states are trying to redefine "substantial nexus" because of widespread Internet business, and that creates even more tax planning problems and audit concerns for businesses—a problem that is easily addressed by automation services.

Automation Solutions

Fortunately, automation solutions are designed to uncover all sales and use tax oversights. The rise in popularity of automated sales and use tax audit solutions represents a major shift in the marketplace. Until the advent of this highly developed technology, only larger corporations with multi-million dollar budgets could afford sales and use tax compliance solutions. Mainstream businesses had no choice but to rely on accounting departments, which, as we've seen, tended to overlook such critical issues as process and workflow. Not any more. Affordable automated solutions are available for businesses of all sizes.

With more sophisticated automation solutions on the market, companies are turning to providers who can prove that their systems offer consistent process and predictable workflow models that provide content and compliance accuracy. For that reason, tax technology companies have become industry thought leaders who have proven themselves capable of developing more cost-efficient and technically sound approaches.

> Automated solutions are now affordable to businesses of all sizes. Cloud-based solutions enable a flexible pricing model for transaction-based fees.
>
> Comprehensive services integrate seamlessly with your ERP and tax decision software to ensure your workflow and processes maximize compliance.

In short, automation is all about preparation. One of its most appealing functions is the ability to provide a consistent, documented, and predictable process, which is exactly what state examiners want to see. The same applies to workflow, which is automated in its entirety from tax preparation through remittance, but not likely found in spreadsheets and accounting-only software.

Any response that lacks what auditors view as critical information is likely to be seized upon as inadequate, and a potential target for a notice of audit. The last thing any company needs is for examiners to question the rationale behind reports and conclude they are merely constructs designed to avoid payment of legitimately owed taxes. This is a point that cannot be understated. Auditors want to reassure themselves about a process that comprehensively explains and justifies each transaction.

Real-Life Examples

Executive Envelope, an envelope and printing solution provider in California, can attest to the importance of process and its impact on audits. The company, a leading provider of printing projects, graphics, and trade show materials with annual sales of $15 million, underwent four consecutive sales tax audits triggered by outdated manual accounting practices for calculating sales and use tax payments. Auditors discovered numerous errors, increasing the company's audit exposure along with the potential for crippling fines. "Our old-fashioned manual process didn't work for us and it was truly broken," said Claudia Brake, office manager.

The company, while recognizing the need to automate its transactions, also required integration with its tax filing process. Executive Envelope chose an automated program that easily integrated into their ERP system and gave the option of selecting a single schedule applicable to all customers while automatically maintaining all tax schedules and details.

The results: the company's audit vulnerability has been diminished and it has not had to face any significant audit issues. Tax amounts are accurate and liabilities are directly submitted by the program to individual state revenue departments. Because the company no longer has to manually update schedules or rate and boundary tax modifications, Executive Envelope estimates a labor cost savings at $36,000 annually.

Executive Envelope's experience demonstrates just a few of the benefits of automated tax calculation and reporting. Here are several others, all of which are important considerations for companies planning their sales and use tax strategies:

- Validation and rate calculations. When there is adequate workflow and process documentation as the basis behind validation and rate calculations, examiners are less likely to challenges the computations.
- Jurisdiction research. Instead of the company spending costly accounting time researching jurisdictional liabilities, the automated system, which is constantly updated, can quickly resolve any questions.
- Potential nexus issues. Several states are attempting to redefine the Quill decision regarding nexus. Through automation, up-to-date nexus definitions are available immediately.
- Exemption certificate management. Automation contains sophisticated logic that can work with complex formulas in states to justify all non-tax reporting as permitted by the certificate. It can greatly reduce, if not eliminate, audit exposure for non-taxed transactions.
- Integration. As was shown with Executive Envelope, automated systems can be integrated into most ERP systems, and financial applications, to increase billing accuracy.

- Manpower cost efficiency. Automated systems have increased capabilities of reducing work time and costs that are lost through manual efforts at compliance.

Businesses may wonder whether the amount of documentation they have is adequate, excessive, or not enough should they receive a notice of audit. The algorithms that enable an automated system's logic eliminate those worries by providing the correct documentation, which helps assure its acceptance by the taxing authority.

Results from the Field

There is no shortage of companies whose experience mirrors that of Executive Envelope in finding that automation greatly reduces their audit exposure, while producing a cost-efficient, tax compliant process.

Logos Bible Software, a global provider of educational software for clergy, students, and missionaries, headquartered in the state of Washington, found that its manual maintenance of tax jurisdictions, sales tax calculations, and timely filing was inconsistent and inadequate for keeping up with the firm's growth. Logos turned to an automated solution, which promptly proved itself after the company received a notice of audit from Texas, its second largest nexus state in terms of sales, according to Andrew Skipton, Logos chief financial officer.

"It was a simple matter of providing the examiner with the monthly reports we used in preparing the tax returns," Skipton said. "Our audit resulted in a no-tax due examination."

The challenge was even greater for the Miner Corporation, an industrial equipment supplier and service provider based in Texas. Miner conducts business in all 50 states, Puerto Rico, Canada, and Mexico. The company has had to deal with thousands of taxing jurisdictions that encompass a variety of cities, counties, and states.

Miner estimates that it has had to endure from 700 to 900 changes in boundaries, tax rates, and regulations yearly. In its previous manual approach, Miner had to calculate its sales tax liability based on each customer's delivery address. Then, sales agents had to conduct time-consuming Internet research to determine the tax rate for each locale and enter it into the sales order. All of this took an inordinate amount of time, approximately 10 to 14 days monthly, to research tax changes, determine proper rates, and file returns.

Minor Corporation, an industrial equipment supplier and service provider who conducts business throughout the US, Canada, and Mexico found they had to deal with thousands of taxing jurisdictions .

As a result, they manually managed 700 - 900 changes in boundaries, tax rates, and regulations yearly. This cost approximately 10-14 days of research time for 1-2 employees *every month.*

Recognizing that automation was its only answer, Miner selected an automated system that performed as promised. Michael McGinn, Miner's senior tax accountant, said an audit that covered the period before and after the new system was implemented, was telling in what it revealed.

"The accuracy and detail after (automation) was far superior, plus the information is readily available," McGinn said. "The auditors were impressed."

A number of additional case studies show similar positive results for users of automated sales and use tax management. Several findings are consistent through all of them: work hours and subsequent costs for compliance are reduced; calculations are performed behind the scenes in the automation process; and tax rates are updated automatically. When validation, rules and formulas are accurate, the company is far less likely to find itself a target on a state department of revenue audit list.

Summary and Conclusion

The costs associated with non-automated approaches to sales and use tax compliance are onerous, unacceptable, and deleterious to the bottom line of the majority of companies. Companies that rely solely on manual accounting solutions or disconnected tax tools that ignore workflow, process, and their role in audit preparation and protection do so at their peril. They may be unintentionally pulling one of those triggers that could lead to an audit notice, an expensive and time-consuming response, and an even more costly—and potentially lethal—finding for recovery.

There is a reason automated solutions represent a cost-efficient and comprehensive solution to the ever-present risk of state audits. They are, in essence, a revolutionary change in a marketplace that has come to recognize a consistent process and predictable workflow for all transactional tax reporting as fundamental to any audit strategy.

Automation is the clearest and best method to graphically display policies and procedures for a competent and, most important, compliant system of tax reporting. Organizations can have peace-of-mind knowing that their automated solution meets and exceeds standards that auditors expect from each business. Just as important—automated tax reporting can greatly diminish audit vulnerability, a best-case scenario for every business.

Endnotes

[1] Aberdeen Group. "Effective Sales and Use Tax Management: Reducing Errors Productivity." May 2010.

[2] Ibid.

[3] U.S. Census Bureau. "Quarterly Summary of State and Local Government Tax Revenue." December 2010.

[4] Ibid.

[5] PayStream Advisors. "Tax Compliance: Cost-Effective Technology and Managed Services Drive Accuracy." March 2009.

[6] Tallman Insights and Mindwave Research. Independent Study of 500+mid-market CFOs and Senior Financial Executives. October 2006.

[7] Ibid.

[8] Ibid.

[9] Ibid.

[10] Ibid.

[11] Quill Corporation v. North Dakota, 504 U.S. 298. 1992.

[12] Nexus determination should result from a detailed nexus study that is conducted with full exposure to the facts of your business. Automated tools are intended to provide general guidance based on well established principles of the nexus creating activities of a business.

About Avalara

Based on Bainbridge Island, Washington, Avalara is transforming the sales and use tax compliance process for businesses of all sizes. With point-and-click ease, Avalara provides the fastest, easiest, most accurate and affordable way for companies to address their sales and use tax compliance. Avalara is the industry's most trusted provider of solutions, serving more than 40,000 registered users located throughout the U.S., Canada and abroad, delivering more than 350 million sales tax transactions, and filing and remitting more than $10 billion in tax collections per year.

For more information about Avalara solutions and services, call 1-877-780-4848 or visit us at www.avalara.com.